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ABSTRACT

This report discusses the objectives of financial statements. Emphasis is placed on the function of objectives; users, their goals, and their information needs; the primary enterprise goal and earning power; accountability and financial statements; financial statements--reporting on the goal attainment of business enterprises; financial statements--historical cost and value considerations; the predictive process and its relationship to objectives; objectives of financial statements for governmental and not-for-profit organizations; the relationship of enterprise goals to social goals; qualitative characteristics of reporting; and a summary of objectives of financial statements. (MJM)

Report of the Study Group on the Objectives of Financial Statements

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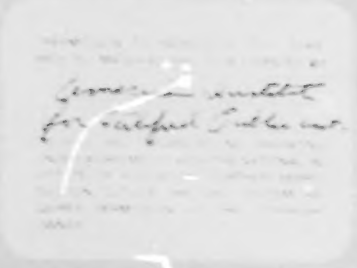
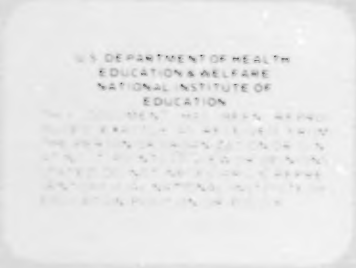
Objectives of Financial Statements





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American Institute of Certified Public Accountants

October 1973

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American Institute of Certified Public Accountants

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ACCOUNTING OBJECTIVES STUDY GROUP

October 1973

Mr. LeRoy Layton, President
American Institute of CPAs
666 Fifth Avenue
New York, New York 10019

Dear Mr. Layton:

The work of the Study Group on Objectives of Financial Statements has been completed. Attached is our final report.

It is the Study Group's view that its report is not of the kind to be accepted or rejected by the members, the Council, or the Board of Directors of the Institute. An effort to identify the fundamental objectives of financial statements does not lend itself to formal adoption. Rather, the report should be regarded as a carefully considered contribution to the profession's literature which must stand or fall on its own merit.

However, the Study Group does express the desire that the FASB will view these report findings as a major effort in the establishment of objectives, to be used as guidelines in judging and testing proposed accounting standards.

By way of recommendations, we suggest the following:

1. The report itself should be given wide distribution to the Institute's membership, to all domestic and international professional organizations, to the business community, to government and the public sector, and to consumer interest groups.

2. An active discussion program or seminar schedule should be developed by the AICPA and other affected organizations—such as was done in the case of the Common Body of Knowledge report and the work of the Institute's Committee on Long Range Objectives.

3. Most importantly, significant efforts should be made to continue progress on the development of objectives from this point on. The objectives of financial statements are not and should not be static, just as the business and financial environment in our country is not static.

Inevitably, an undertaking of this scope and complexity gives rise to differing opinions, and it is therefore not surprising that individual members of the Study Group might have preferred a somewhat different presentation or wording at various points in the report. But all of the members of the Group are satisfied that the accommodation of divergent views in the course of their deliberations has helped to achieve the goal of a coordinated and consistent statement of accounting objectives.

The Study Group deeply appreciates the substantial contributions which have been made by a number of firms in supplying manpower for extended periods of time and the product of their internal research—as well as direct contributions toward financial costs. The sincere interest, as well as the extended participation of many individuals and professional groups in this country and across the world, has been equally heartening.

This report is submitted to you for your consideration by the entire Study Group with the hope that our efforts will make some contribution to the development of financial reporting.

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Sidney Davidson
James Don Edwards
Oscar S. Gellein
C. Reed Parker
Andrew J. Reinhart
Robert M. Trueblood
Howard O. Wagner
Frank T. Weston

CONTENTS

Preface 9
Background 9
Research Plan and Method 9
Report Format 10

1 **The Function of Objectives — An Overview** 13
Economic Decisions—The Allocation of Resources 14
Objectives, Standards, and Practices—Their Relationship 15
Criticisms of Present Accounting 15

2 **Users, Their Goals, and Their Information Needs** 17
Components of Economic Decisions 17
Similar Information Needs of Users 18
The Loan Decision 19
The Investment Decision 19

3 **The Primary Enterprise Goal and Earning Power** 21
Measuring Accomplishments of the Enterprise in Terms of Its Goals 21
The Role of Accounting 22
Accounting and Economic Earnings 22
Earning Power 23

4 **Accountability and Financial Statements** 25

5 **Financial Statements – Reporting on the Goal Attainment of Business Enterprises** 27
Indicators of Success in Attaining Enterprise Goals 27
Earnings Cycles 27
Classification of Earnings Cycles 28
Usefulness of Earnings Cycle Classification 29
Identifying Progress Toward Earnings Cycle Completion 30
Information to Be Presented in Financial Statements 31
Earnings in Financial Statements 31
Reporting and Communicating Success in Achieving Enterprise Goals—Nature of Information 33
Statement of Financial Position 35
Statement of Earnings 36
Statement of Financial Activities 37

Desirable Features of All Financial Statements 39
Communicating in Single Numbers and Ranges 39

6 Financial Statements—Historical Cost and Value Considerations 41

7 The Predictive Process and Its Relationship to Objectives 45
Conventional Financial Statements and Judgments About the Future 45
Information Useful for Assessing the Future 45
Financial Forecasts—Accuracy and Utility 46
Reporting Forecasts or Projections 46

8 Objectives of Financial Statements for Governmental and Not-for-Profit Organizations 49
Decisions About Governmental and Not-for-Profit Organizations 49
Objectives of Financial Statements for Not-for-Profit Organizations 50

9 The Relationship of Enterprise Goals to Social Goals 53
Reciprocal or Direct Interactions 53
Nonreciprocal or Indirect Interactions 54
The Measurement and Reporting of Social Interactions in Financial Statements 54

10 Qualitative Characteristics of Reporting 57
Relevance and Materiality 57
Form and Substance 57
Reliability 58
Freedom From Bias 58
Comparability 59
Consistency 60
Understandability 60

11 A Summary of Objectives of Financial Statements 61

Charter 67

Terminology Index 69

Index of Selected Papers—Volume II 70

PREFACE

The Study Group on the Objectives of Financial Statements was appointed in April 1971, by the then president of the American Institute of CPAs, Marshall S. Armstrong. The Study Group is aware of the far-reaching effects that a study of this type can have on the evolution of financial reporting. The Group attempts in this study to develop objectives that will provide direction to this evolution.

Background

This Study is not the first effort by a professional body to deal with the subject of financial statement objectives. The Accounting Principles Board of the AICPA approached the problem tangentially in Accounting Research Studies Nos. 1 and 3, *The Basic Postulates of Accounting* and *A Tentative Set of Broad Accounting Principles for Business Enterprises*. The American Accounting Association discussed some aspects of objectives in *A Statement of Basic Accounting Theory*. The APB's Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, dealt with broad, qualitative objectives. More recently, the Australian Accounting Research Foundation published its Study No. 3, *Objectives and Concepts of Financial Statements*, which also encompassed a broad approach to objectives. Each of these past studies has provided useful views of a complex subject.

If this report makes a similar contribution, the Study Group will have met its charge. The extent to which conclusions reached in this Study are different from those reached in previous inquiries may be largely due to differences in approach and method. The creation of a functional framework on which accounting standards can be based has been a continuing aim of this Study.

Research Plan and Method

The Study Group has sought ends, not means. The attempt to reach goals implies that such goals can be identified and understood. The accounting profession has authorized this inquiry to seek goals that relate to its principal concern—the information presented in financial statements.

Given the breadth and the unusual nature of its task, the Study Group established the broadest boundaries of inquiry that its assignment and resources would allow. Although the Study Group adopted few constraints and restrictions, its members agreed to concentrate on the financial environment of the United States.

The Study Group concluded that the development of objectives should not be based on the operating needs of the managers of businesses, but

rather on the needs of users of financial information outside enterprises or organizations. Managers, of course, are both preparers and users of financial statements. The Study Group has considered its charge broadly and holds that many of its conclusions are applicable outside its specified boundaries. While mindful of the importance of the audit function, the Study Group has been primarily concerned with the nature of information and not its attestability.

The project has spanned almost two years and has involved an interdisciplinary commission of nine members, a staff of academicians and accounting practitioners, and special consultants and observers. In addition to accounting, the disciplines of economics, financial analysis, law, management, mathematics, and sociology have been represented in the Study Group's deliberations.

In the activities and empirical investigations leading to this report, the Study Group solicited the views of more than 5,000 corporations, professional firms, unions, public interest groups, national and international accounting organizations, and financial publications. The Study Group conducted more than 50 interviews with executives from all sectors of the business and professional communities and in government. To elicit the widest possible range of views, 35 meetings were held with institutional and professional groups representing major segments of our economy. This process culminated in May 1972, when the Study Group held three days of public hearings in New York to obtain further clarification of users' needs. Twenty-five firms, organizations, and individuals made formal presentations or submitted proposals at these sessions. The transcript of these proceedings is a public document available for purchase from the AICPA.

The Study Group began with a review of pertinent writings in accounting, economics, and financial analysis. The resulting bibliography, which is to be part of the selected papers supporting this Study, represents an attempt to extract from the literature those objectives that now underlie financial reporting.

The next step was an inquiry into the suitability of economic decision models as a foundation for meeting the information needs of users. In this approach, the Study Group attempted to examine the ideal, unfettered by present problems of application or by the limits of technology.

The substantial empirical and conceptual data resulting from these activities provide the bases for many of the conclusions in this report.

Report Format

The report of the Study Group consists of three parts. This monograph, the first part, presents both the conclusions of the Study Group and some discussion of the rationale for the stated objectives.

The second part, to be published separately, will include a selection of research papers, illustrative statements, and experimental project summaries, all of which are meant to provide greater development of the underlying subject matter. Although the Study Group used substantial portions

of this material in its deliberations, all of those papers and their conclusions should be viewed in large measure as independent research efforts of the identified authors.

The third part consists of the record of the Study Group's entire proceedings. This chronology and public record will eventually be available for review at the AICPA offices in New York.

The Study Group concludes that the objectives developed in this report can be looked upon as attainable in stages within a reasonable time. Selecting the appropriate course of action for gaining acceptance of these objectives is not within the purview of the Study Group. The Study Group urges that its conclusions be considered as an initial step in developing objectives important for the ongoing refinement and improvement of accounting standards and practices.

CHAPTER 1

The Function of Objectives—An Overview

Accounting is a social system much like language and law. As such, it tends to evolve by adapting to its environment; but evolutionary changes may occur which are incompatible or even in conflict with current notions of what the objectives of this system ought to be. An explicit statement of objectives, therefore, is essential to its rational development.

The Study Group sees the defining of objectives mainly as a means for evaluating desirable goals and helping to achieve them. The Study Group recognizes that the development of objectives is ongoing. Its conclusions are in no sense unalterable or unchanging.

The fundamental function of financial accounting has been unchanged almost from its inception. Its purpose is to provide users of financial statements with information that will help them make decisions. Of course, there have been substantial changes in the types of users and the kinds of information they have sought. Nonetheless, this function of financial statements is fundamental and pervasive:

> **The basic objective of financial statements is to provide information useful for making economic decisions.**

To accomplish this basic objective, it may be that financial statements should not be limited solely to quantified information. Amplification, in narrative form, of data included in statements may be required.

The overriding objective of financial statements emphasizes the output of useful information rather than the accounting process itself. The objective is not directed toward recording or reporting for their own sake. This basic objective requires that every accounting objective, standard, principle, procedure, and practice should serve users' needs.

Users' needs for information, however, are not known with any degree of certainty. No study has been able to identify precisely the specific role financial statements play in the economic decision-making process. This Study is therefore dependent upon certain assumptions about users' information needs and their decision processes. These assumptions are supported by research available to the Study Group and are believed to be consistent with economic and behavioral theory:

- Users of financial statements seek to predict, compare, and evaluate the cash consequences of their economic decisions.

- Information about the cash consequences of decisions made by the enterprise is useful for predicting, comparing, and evaluating cash flows to users. (If the value of the unit of measure is unstable, that is, if inflation or deflation is so great that direct cash consequences are no longer comparable, such circumstances should be recognized in the financial statements.)

- Financial statements are more useful if they include but distinguish information that is primarily factual, and therefore can be measured objectively, from information that is primarily interpretive.

The objectives of financial statements developed in this Study are intended to follow logically from these assumptions.

Economic Decisions – The Allocation of Resources

The basic objective—"to provide information useful for making economic decisions"—applies within a broad economic environment. An economy is organized to strive for efficient allocation of resources. This allocation is affected by government action and by private actions in the marketplace, or some combination of the two. Both kinds of actions involve economic decisions and require financial information.

In the United States, where the economic system emphasizes private enterprise, individuals and enterprises generally attempt to maximize their own wealth. Financial information helps them make sound economic decisions. This process is assumed to lead to the broader social goal of the efficient allocation of resources throughout the economy.

In our economy, the attainment of individual economic goals often is encouraged by laws, such as those that define property rights, promote competition, and establish efficient markets. Such laws may be changed when society determines that the effects of private economic decisions no longer best serve the public interest. For example, laws are passed which directly or indirectly alter the distribution of wealth, regulate monopolies, and seek to improve social welfare and the quality of life. Our society attempts to reconcile the results of individual economic decisions with the public interest.

In developing financial statement objectives, it would have been possible to consider economic decisions as though they involved only individuals and business enterprises. If this were done, others would doubtless attempt to modify the objectives to recognize the public interest. The Study Group prefers the development of financial statement objectives by a professional, as distinguished from a political, process. In formulating financial statement objectives, the Group considered the needs of those who make decisions about the public interest to assure that financial reporting would be responsive to that larger interest as well.

The identification of the primary users and of the financial information they need is fundamental to the operation of the basic objective. Additional financial statement objectives should follow from this identification.

Objectives, Standards, and Practices — Their Relationship

To serve users' needs, the accounting process should consist of an interrelated and compatible system of objectives, standards or principles, and practices or procedures. Objectives should identify the goals and purposes of accounting. Standards should follow logically from objectives, and should provide guidelines for the formulation of accounting practices compatible with the desired goals. All three levels of the system should be linked rationally to the needs of users. Otherwise the development of objectives becomes a sterile activity which cannot be justified.

Moreover, standards and practices that do not fulfill objectives are aimless and difficult to justify, modify, or control. Therefore, each practice should relate to standards and each standard to objectives that identify the purpose of the standards and practices. This process permits an assessment of the ability of standards to bring about the desired goals. It also permits the orderly revision of practices to improve the degree to which they implement standards and serve changing needs.

Objectives, standards, and practices are so intertwined that they are difficult to separate. The Study Group has been concerned primarily with objectives, but at times it has had to consider means of application in order to develop useful objectives.

Criticisms of Present Accounting

As the economic activities of businesses have become more complex and diverse, those users outside the immediate ownership and management of enterprises have sought more financial information. Outside investors, creditors, governments, and employee and consumer organizations have become more than casual users of financial statements. As needs have increased, financial statements have become more elaborate and complex.

As a result, many of the practices of financial accounting such as the following are under severe criticism:

- Accountants have considered themselves primarily historians, not prophets. Financial statements have reported on past performance, but not explicitly on future prospects. However, even present accounting practices require estimates of the future. For instance, the amounts shown for assets in balance sheets imply that enterprises will recover at least those amounts from their future use or sale. Considerable current debate centers on inclusion of explicit predictions of a broader nature in financial reports.
- Accounting measures generally have been based on the results of exchange transactions. Historical costs of resources and obligations only coincidentally reflect their current values. Those who advocate

current values suggest that accounting should not be restricted to values based only on these past exchange transactions.

- Accounting frequently involves choices among alternative methods. When like things are not reported alike, users of financial statements have difficulty comparing competing economic opportunities. Moreover, it is suggested that the selection of accounting alternatives has sometimes been made in an attempt to influence reported earnings rather than to reflect actual economic change. Although no accounting structure can be designed which eliminates all reasonable alternative methods for treating like circumstances, it is argued that comparability should be the overriding consideration for choosing among methods.
- Accounting has emphasized general purpose financial statements. But it is claimed that various users require different kinds of financial statements to satisfy their various needs.
- In the basic financial statements now prepared, key amounts in one statement relate directly to amounts in other statements. Statements related in this way are said to articulate—a requirement considered by some to be unduly restrictive. They claim that independent or unrelated representations in statements would increase their usefulness.
- Assertions have been made that present financial statements do not provide sufficient information about the liquidity and cash flows of an enterprise.
- Changes in purchasing power of the monetary unit have been substantial, and it is claimed that these changes should be recognized formally in financial statements.
- Materiality has long been integral to financial reporting. But there are some who question whether this concept is defined and communicated adequately to prevent its misuse.

In evaluating these criticisms, it should be remembered that accounting is a social system based largely on conventions or traditions. Many of these conventions are now being challenged. Official pronouncements of the profession have not, to date, provided a framework for meeting these challenges.

Financial accounting has attempted to meet users' increasing needs. But these efforts often have taken the form of judgments that were not based on a formal plan. Further, such changes often have been made without eliminating the older, less preferable practices they have been intended to replace. This is, in part, a product of the fact that no operational framework for financial statement objectives has ever been explicitly formulated.

Accountants have recognized that explicit objectives of financial statements can serve to retain what is good in accounting, to develop new benefits, and to reject less desirable practices and procedures. Given explicitly stated and consistent objectives and their general acceptance, the boundaries of accounting will be influenced primarily by users, their goals, and their needs for information.

CHAPTER 2

Users, Their Goals, and Their Information Needs

Some users of financial information can obtain more information about an enterprise than others can. This is clearly so for managers, but it also holds true for others, such as large-scale equity investors and creditors. For example, in a private placement of securities, the prospective investor may receive more information about the company, both before and after making his investment, than would an investor in a public offering. Other economic decision-makers also have significant resources available to obtain information and to analyze it. These decision-makers often have access to much more information than is available to users of general purpose financial statements.

Financial statements are, accordingly, especially important to those who have limited access to information and limited ability to interpret it. Therefore, users who ordinarily rely on financial statements alone may be served most by developing accounting objectives. Financial statements should meet the needs of those with the least ability to obtain information and the needs of others as well. Consequently,

> **An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.**

Though users who rely on financial statements are of different types, they have certain similar information needs. The identification of these needs requires exploration of economic decision-making by these different users.

Components of Economic Decisions

Economic decisions deal with some matters which can be measured with precision and with others for which measurement is subjective. For example, in deciding whether to sell a bushel of wheat for cash, the seller can estimate with some precision the expected benefit from sale, that is, the proceeds. Whether the amount of the proceeds is such that the seller is better off, and by how much, is a matter that only he can judge.

A common element of all economic decisions is a comparison of what

must be given up with what can be expected to be received. The amounts and timing of known or estimated disbursements and receipts are weighed against an assessment of any attendant uncertainties. Judgments are made about each component, and the decision typically is tested against alternative courses of action.

Two components of economic decisions usually can be identified and quantified. These are (1) *sacrifices*—defined as anything prized or desirable which is given or used up—and (2) *benefits*—defined as anything prized or desirable which is received.

It is assumed that those who make economic decisions prefer to accelerate and increase benefits and to defer and reduce sacrifices. But the economic decision-making process would not require analysis if all the sacrifices and benefits of alternative courses of action were known with certainty. Clearly, uncertainty and the resulting assessment of risk are critical elements in the decision-making process.

Risk applies to measures of prospective sacrifices and benefits in two ways: uncertainty about amounts and uncertainty about timing. For example, in a daily auction, risks related to amounts are usually great, while those relating to timing are virtually nonexistent. Conversely, a typical life insurance policy contemplates a considerable risk of timing of the death benefit but little or no risk in the amount of the benefit.

Although economic decisions are made by many kinds of individuals and organizations, each decision is directed toward a goal. The goal of an unsophisticated occasional investor may be general: to increase his wealth. Others, making decisions within a formal plan, may have goals which specify intricate parameters for amount, timing, and risk. All decision-makers, however, have to live with uncertainty, and all are affected by the varying degrees of risk. But each has his own preference for the degree of risk he is willing to assume.

Similar Information Needs of Users

Economic decisions about commercial enterprises are made principally by present or potential investors in equity securities, by creditors, and by managers and employees who invest time or effort. Others, such as regulators, also make decisions that affect the enterprise. But regulators are, in turn, only indirectly affected by their decisions, since they do not directly receive the benefits or incur the sacrifices.

Classifying users as investors, creditors, and managers is helpful in discussing their principal activities. While users may differ, their economic decisions are similar. Each user measures sacrifices and benefits in terms of the actual or prospective disbursement or receipt of cash. Further, the distinction between an investment and a credit decision often is not sharp. Therefore, the extremes of a simple direct loan and a common stock investment will be used to illustrate the underlying similarity of decisions.

The Loan Decision

In a loan decision, the lender knows the amount of the loan requested and the terms of repayment of principal and interest. The lender seeks to determine the borrower's ability to repay in accordance with the terms. This is not subject to precise measurement, although it may well be judged on a scale such as that used by credit rating services. In most situations, no single bit of information—stockholders' equity, net earnings, cash flows, or capital position—can provide the lender with an assured measure of the borrower's ability to repay. Thus the credit decision, like all economic decisions, requires an assessment of risk.

Lenders are generally interested in a specified return and degree of risk. Because of market or legal restrictions, lenders frequently have a narrow range of possible returns but a broad range of prospective borrowers. A lender can reduce his risk by being selective among borrowers provided he has enough information about them to make predictions based on his preferences for amount, timing, and uncertainty of cash returns. Lenders also need enough information about borrowers to determine the degree of control or influence they wish to impose through such loan provisions as future reporting requirements, and restrictions on dividend payments or on additional borrowing.

The Investment Decision

Decisions of common stock investors concern buying, selling, or holding. Both buyers and sellers choose among competing opportunities. A buyer knows what he must give up to acquire a stock, but he is uncertain about the amount and timing of what he will receive in the future, either as cash dividends or as proceeds from the sale of his investment. A seller knows the proceeds he can receive at any given time, but he is uncertain about future cash dividends and the future selling price.

Both the investor and the creditor want more cash returned to them—either by the enterprise itself or in the marketplace—than they gave up. This seems fairly uncomplicated in the simple loan decision in which the enterprise itself will return stated amounts of principal and interest. But the investment decision is more complicated because of the intervention of the investment market.

Investors expect to receive more than they invest because of the flow to them of dividends and of sales proceeds from another investor, who, in turn, also expects future dividends and sales proceeds. The chain from investor to investor continues as long as investors perceive the company to have value. The value of the security derives from these expectations.

To illustrate this point, consider an enterprise that was formed today and will be terminated and liquidated ten years from now. Assume further that the enterprise, which is publicly owned, will not pay dividends prior to liquidation. A prospective investor assesses the enterprise's plans and prospects and estimates the return ten years hence. If the expected return meets his preferences for amount, timing, and related uncertainty, the investor buys the security.

Assume the enterprise's performance exceeds the expectations of this initial investor. Barring other factors, the market price of the stock can be expected to increase with the market's assessment of the enhanced prospects for the company. Without perfect knowledge, this assessment will depend on more than a single measure of past or anticipated performance. It will be a composite of individual expectations and preferences for amount, timing, and related uncertainty of receipts.

Continuing with the illustration, assume, as an extreme, that a law is passed outlawing the enterprise's business activity and expropriating all proceeds expected from liquidation. The market price, of course, will approach zero as the future prospect of return all but disappears.

Investors, like creditors, are interested in activities that affect their prospects for receiving more than they gave up. In deciding to buy a common stock, the investor considers the ability of the enterprise to pay dividends currently, prospectively, or even at liquidation. He is also, obviously, interested in the stock price movements that reflect that ability.

Individual investors may choose not to be concerned with a company's dividend policy. In the hope of generating still more funds for dividends or further reinvestment, many enterprises reinvest funds instead of paying them as dividends to investors. Investors approve such reinvestment if they expect it to enhance future dividend prospects and be reflected in market prices that increase enough to compensate for the present dividends they forgo.

Short-term investors may argue that they are not concerned with the enterprise's dividends, because market prices may increase in the short run for other reasons. In the long run, however, the market does concern itself with actual and prospective dividend payouts. Barring other complications, security prices rise and fall with changes in investors' expectations about the enterprise's ability to pay future dividends.

Thus, the information needs of creditors and investors are essentially the same. Both groups are concerned with the enterprise's ability to generate cash flows to them and with their own ability to predict, compare, and evaluate the amount, timing, and related uncertainty of these future cash flows. Therefore,

> **An objective of financial statements is to provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows to them in terms of amount, timing, and related uncertainty.**

The information most useful in assessing a corporation's ability to pay dividends and interest obviously derives from its success in reaching its goals.

CHAPTER 3

The Primary Enterprise Goal and Earning Power

The primary and continuing goal of every commercial enterprise is to increase its monetary wealth so that over time it can return the maximum amount of cash to its owners. The enterprise's efforts to attain this goal are affected by at least three factors: (1) the level of risk the company is willing to accept, (2) the restrictions inherent in the line of business it chooses, and (3) the constraints imposed on it by society. In support of this primary goal, the enterprise usually pursues a number of specific goals, such as obtaining financial resources to fund planned operations, providing for a skilled labor force, and otherwise maintaining the ability to adapt to economic change. The enterprise acts in many ways to reach these goals. Typically, it uses cash to generate more cash; it forgoes present gains when it expects that such a choice will produce larger long-term gains; it develops managers; it invests in plant and equipment; it allocates resources to research, advertising, public relations, and other intangibles. But whatever activities the enterprise pursues, its primary goal of maximizing wealth by using cash to generate more cash remains essentially unchanged.

The achievement of the primary goal can be measured meaningfully only over relatively long periods of time and, with precision, only when the enterprise is ultimately dissolved. But measurements for a time span which runs to dissolution are not useful. Economic decision-makers need continuous information about the enterprise's degree of success periodically before dissolution, because they make decisions every day.

Measuring Accomplishments of the Enterprise in Terms of Its Goals

It can be argued that measuring the accomplishment of the enterprise in terms of its goals may not be useful for outside economic decision-makers, because their primary interests are in the purposes or aims of their own investment or lending programs. However, decision-makers should want to know whether they achieve their personal goals incidentally or as a direct or indirect result of the enterprise's reaching its own goals. In other words, outside decision-makers need information about such matters as whether the company increased its dividends because it earned more or

because it simply decided to pay out more. Similarly, they need to know whether earnings increased as a result of improved performance, fortuitous circumstances, or a change in accounting methods. That is, decision-makers can evaluate the enterprise's progress only with information about the enterprise's economic decisions and their consequences.

The Role of Accounting

A fundamental purpose of accounting is to provide interim measures of enterprise progress. The measurements made by accounting should relate to the enterprise's goal of producing the most cash for its owners. These measurements, therefore, should emphasize the actual or prospective disbursement or receipt of cash. Users need to know about probable cash movements of an enterprise to estimate cash flows to them. The periodic measurement of earnings by enterprises becomes a basis for these estimates. The problem of reporting enterprise progress is complicated because most enterprises engage in a variety of efforts to achieve their goals, many of which have long-range consequences. Nonetheless, the purpose of the periodic accounting measure of earnings is the same—to measure enterprise progress toward its goal—whatever the time span of the consequences.

Accounting and Economic Earnings

Economists generally agree that income is the change in well-being or "better-offness" that occurs in specific time periods. But economists' measures of these changes in well-being or better-offness are not well defined in terms of the operational aspects of an enterprise.

Accounting income or earnings should measure operations and represent the period-by-period progress of an enterprise toward its overall goals. Accounting measurements of earnings should recognize the notion of economic better-offness, but should be directed specifically to the enterprise's success in using cash to generate maximum cash.

With perfect knowledge, economic and accounting earnings as measures of better-offness would be readily determinable and would be identical. With such knowledge, earnings for a period would be the change in the present value of future cash flows, discounted at an appropriate rate for the cost of money.

But the real world does not afford decision-makers the luxury of certainty. Earnings, therefore, are based on conventions and rules that should be logical and internally consistent, even though they may not mesh with economists' notions of income. Enterprises have attempted to provide users with measures of periodic earnings. Present accounting practice seeks to base such measurements on performance—services rendered. Since these measures are made without benefit of certainty, they are of necessity imprecise, because they are based on allocations and similar estimates. Many current controversies over accounting methods are rooted in this aspect of earnings measurement. A significant question, therefore, relates to whether accounting measurements of earnings can in fact be made more useful to those with varying interests in financial statements.

Users' continuing needs for assessing performance make the measurement of periodic earnings an overriding matter. There is an inexorability about the calendar. Economic decision-makers want information which is sufficiently timely to assist them in assessing a company's accomplishments over relatively short periods. This information should help decision-makers to predict future accomplishments.

Earning Power

Given appropriate financial information, the decision-maker can evaluate the enterprise's potential. This judgment aims at estimating the enterprise's ability to be better off, to generate more cash, and to have earnings convertible into cash at some future date. This ability is the enterprise's *earning power*.

Enterprise earning power has as its essence the notion of ability to generate cash in the future. Cash generating ability and earnings are closely related and the longer the period, the closer the relationship. For a relatively short period like a month, a quarter, or even a year, net cash flows (other than capital changes) will differ from earnings because of changes in such items as receivables, payables, inventories, and plant. For such relatively short periods, the accrual basis provides a more useful measure of enterprise progress than the cash basis. Over longer periods, cash generation and earnings come closer together. Over the entire life of an enterprise, they are the same. That is, earnings can only come from cash generated by operations; cash generating ability and earning power are equivalent.

Thus, the overall concept of earning power represents the enterprise's ability to achieve its ultimate goal of providing maximum cash to its owners. But, since the future is uncertain and since users differ in their responses to uncertainty, such a measure is necessarily subjective at any time.

Users assess the earning power of publicly held enterprises virtually every day. Market prices of their securities reflect composite assessments of earning power and the implicit ability to pay dividends. Financial statements are prepared to assist in this assessment. As time passes, enterprises demonstrate their success or failure in reaching their goals. Earnings are determined and reported, and dividends are paid out. Information about past earnings is significant for evaluating enterprise earning power, except when the past is not a valid portent of the future.

Financial statements should provide users with information for predicting, comparing, and evaluating earning power. This information should be designed to allow users to apply their own judgments and preferences based in part on additional information—especially current events. Financial statements are not the ideal medium for reporting current developments, since they are prepared periodically in a systematic and comprehensive manner. Particular events that may bear on economic decisions about an enterprise are likely to be public knowledge before the enterprise can include them in its financial statements.

Clearly, financial statements are not suited to the communication of all information that may have an impact on economic decisions. But they are useful in assessing earning power. Therefore,

> **An objective of financial statements is to provide users with information for predicting, comparing, and evaluating enterprise earning power.**

If financial statements are to serve those users who rely on them as principal sources of information, users' needs should be paramount in guiding the preparation of financial statements. Relevant judgments of the preparer include the selection of information, as well as its measurement. Those judgments should be tested continuously against established needs of users.

CHAPTER 4

Accountability and Financial Statements

Whoever has a responsibility to others for his actions and their consequences is accountable to them. That responsibility may derive from law, contract, organization policy, or moral obligation.

Accountability is a broad term that encompasses stewardship. Stewardship refers to the efficient administration of resources and the execution of plans for conserving and consuming them. Reporting on management's stewardship has long been recognized as a principal purpose of financial statements. However, management's responsibilities are broader than those implied by stewardship alone.

The lines of responsibility comprising accountability are intertwined. Within a company, managers are accountable to directors who, in turn, are accountable to shareholders. Within enterprises, management accountability follows various organizational lines.

The enterprise itself is accountable to those who furnish resources, that is, to its creditors and its owners. Society may impose broad and at times unspecified, but nevertheless implicit, responsibilities. And an enterprise may voluntarily assume certain social responsibilities. The enterprise is accountable for its actions, or inactions, in discharging a wide range of responsibilities.

One significant aspect of accountability arises when an enterprise offers its securities to the public; then, the enterprise becomes responsible to all who make economic decisions about its securities. In other words, the enterprise is responsible for the information provided to all investors—past, present, and potential.

Accountability extends beyond the element of stewardship involved in the safekeeping of assets entrusted to custody. It encompasses the use and conversion of those assets as well as decisions not to use them. Management is accountable for the values of assets as well as for their costs. Enterprise managers are also accountable for actions taken to hedge against the economic impacts of inflation and deflation and technological and social changes.

Since the principal goal of a commercial enterprise is to maximize cash return to owners, its management is accountable for progress toward this goal. Information useful for estimating earning power becomes equally useful for assessing accountability. To estimate earning power, it is neces-

sary to predict the outcome of management actions. Accountability, in turn, deals with management's responsibility for taking or not taking actions and for the outcome of those actions.

Financial statements, some contend, should direct information primarily to users so that they can assess management responsibility for past activities. Some believe that if this were to be the overriding accounting objective, information aimed at this objective would focus solely on history. That philosophy would reduce significantly the value of statements not only for predicting future earnings, but also for assessing accountability.

If financial reporting were restricted to this narrow historical approach, users would be provided with only an absolute measure of management performance rather than with comparative measures. For example, after a year of record earnings determined on a strictly retrospective basis, it could be concluded that since management performed better than in previous years, it ought to be rewarded accordingly. Such a rating of performance would imply as its standard the limited measure of performance in previous years rather than more realistic ones based on enterprise goals formulated in a contemporary economic context.

Some past actions of the enterprise may be part of a series of events intended to have future consequences. Therefore, these past events cannot be assessed without considering their probable outcome. In other words, accountability requires that information be provided about potential as well as actual results. Quite apart from any need to predict, users are better served when they have information about the present and future as well as the past. Accountability involves the reporting of periodic measures of progress toward enterprise goals. Thus, measures useful for assessing earning power are also useful for holding management to account:

An objective of financial statements is to supply information useful in judging management's ability to utilize enterprise resources effectively in achieving the primary enterprise goal.

The concept of accountability does not prevent a reorientation of financial statements. Rather, accountability provides a basis for disclosing information needed for assessing expected performance as well as for reporting on the past. The economic decisions of users establish the need for information about past and future goal attainment of an enterprise. Accountability asserts the preparer's responsibility to provide that information.

CHAPTER 5

Financial Statements – Reporting on the Goal Attainment of Business Enterprises

Financial statements provide much of the information that economic decision-makers use to assess the earning power of business enterprise. A clear identification of objectives can make financial statements function better as sources of this information.

Indicators of Success in Attaining Enterprise Goals

Enterprises are continuously involved in many kinds of planned and managed activities. Yet everything that affects an enterprise cannot be controlled or managed. Nor is everything that occurs relevant to the enterprise or to its efforts to achieve its goals.

For purposes of this discussion, therefore, those changes in conditions, stages, or circumstances that affect the enterprise are defined as *events*. Events may be exchanges between parties, that is, transactions. Or events may be occurrences that affect the enterprise without being exchanges in the usual sense of the word.

All business enterprises engage in related activities aimed at goals. These related activities are defined as *cycles*. The overriding and commanding cycle of an enterprise encompasses all the activities in its life from its inception to its dissolution. Within that life span there are other cycles and subcycles of transactions and other events. Some of these cycles are readily identifiable, others are not.

The earning process consists of effort and performance directed at reaching the primary enterprise goal of returning, over time, the maximum amount of cash to its owners. The activities that are part of the earning process of the enterprise can be related to earnings cycles.

Earnings Cycles

Since the goals of an enterprise and its earning process involve the use of cash to generate the maximum amount of cash, earnings cycles should relate cash receipts and disbursements.

The central elements of an earnings cycle are these: an actual cash disbursement or an event involving a highly probable cash disbursement;

a related actual cash receipt or an event involving a highly probable cash receipt; and the efforts or events inherent in the earnings process.

Highly probable receipts and disbursements are stressed to indicate the substantive nature of the information about cash flows, rather than the formality of actual receipts or disbursements. Determining what is highly probable is a judgment requiring substantial evidence that no significant degree of uncertainty exists about either the amount or timing of future cash flows. Although in reality it may be difficult to pinpoint the exact beginning and end of an earnings cycle or to set forth a rigorous definition of what is highly probable, these concepts are nonetheless helpful in classifying transactions and events in the earning process.

The accrual method evolved primarily in response to the need, in meeting the purpose of periodic reporting, to quantify and communicate information about substantive activities other than cash payments and receipts.

Classification of Earnings Cycles

An earnings cycle can be classified as completed, incomplete, or prospective.

For an earnings cycle to be defined as completed, three conditions should be fulfilled: (1) a *realized sacrifice* (an actual or highly probable disbursement of cash), (2) a related *realized benefit* (an actual or highly probable receipt of cash), and (3) no further related substantive effort.

For example, land is purchased for cash and is sold either for cash or a note, the collection of which is highly probable. No further obligations then exist for substantive effort on the part of either buyer or seller. This cycle is completed since all benefits and sacrifices have been realized without the need for further substantive effort.

Conversely, a publishing company collects dollars from subscriptions and contracts and pays cash for paper to be used in fulfilling the subscriptions. Although a realized benefit and part of the related realized sacrifice have occurred, the earnings cycle is not completed because the substantive effort of publishing required by the benefit has not been performed and further sacrifices are to be incurred.

In still another example, the sales of subdivided land for long-term notes, collection of which is not highly probable, do not represent completed earnings cycles. In this case, even though no further effort is required, the benefit has not been realized.

Occasionally, there may be a situation in which both realized sacrifices and related realized benefits occur without an identifiable effort taking place. Such windfalls, although unusual, should be defined as completed cycles since they meet the specified conditions—presence of realized sacrifices and benefits and absence of further required effort.

Thus, a completed earnings cycle involves a series of events whose entire impact on enterprise earnings and earning power is considered to have occurred.

The earnings cycle is defined as incomplete (1) when a realized sacrifice or a benefit has occurred, but the related benefit or sacrifice has not been realized, (2) when both sacrifice and benefit are not realized, or (3) when the effort has not taken place. For example, machinery is acquired, material is purchased, services of labor are used, or other sacrifices are made, but no transaction or other event has occurred that would result in a realized benefit, and further substantive efforts such as production and marketing are required.

An earnings cycle may be defined as prospective whenever plans have been adopted or unilateral actions taken but neither a sacrifice nor a benefit has occurred. Examples of prospective earnings cycles are the receipt of an order, a purchase commitment, or the adoption of next year's budget.

A simple earnings cycle may be identified quite easily; but for most series of transactions, it is usually difficult to determine when a cycle has been completed. For example, an enterprise makes a sacrifice by purchasing a plant to produce goods. In this case, the sacrifice (the cash disbursed) can be identified. But the benefit (the cash receipt) relates in some way to each unit being made, sold, and eventually realized as cash. A further benefit may arise from a cash receipt on disposal of the plant. Until the plant is sold, some of the benefits relating to the initial sacrifice for the plant will have been realized through its use in manufacturing, and some will not. Therefore, this requires estimates of the amount of the sacrifice applicable to a certain time period, whenever all benefits are not realized within that time period. Such allocations of sacrifices (or of benefits in other situations) introduce the need for additional judgments in accounting for cycles.

Cycles often overlap in time. For example, the earnings cycle of a plant is integrally linked with the earnings cycle of the product and these cycles have different time spans for completion. To determine periodic earnings, a decision is required as to which of these is to be considered dominant for establishing the completion of a cycle. In general, the earnings cycle of product or service is considered dominant. This requires that all sacrifices and benefits relating to other earnings cycles be allocated to the product or service earnings cycle. Thus, a product or service earnings cycle can be considered as completed even though other overlapping cycles remain incomplete.

Usefulness of Earnings Cycle Classification

The classification of earnings cycles as completed, incomplete, and prospective may be abstract and difficult to define operationally. Further, the operations of a business enterprise are too complex and interrelated to be expressed in a series of easily definable earnings cycles. Some members of the Group believe that the notion of an earnings cycle as described herein represents a simplistic and/or impractical approach to the measurement of accounting earnings. There is no doubt that a pure earnings cycle

is rare in the activities of corporate enterprises. As a result, there are situations in which the approach suggested in this Study might be considered to be artificial and perhaps even illogical.

The Study Group members recognize these difficulties. However, the majority of the Group believes that the earnings cycle concept is useful because the classifications derived from the concept assist users in evaluating uncertainties and the earning power of the enterprise. Grouping related events in terms of cycles helps to

- Distinguish those transactions and other events having expected future consequences from those that do not.
- Highlight the differences in uncertainty of cash realization of various business activities.
- Indicate the extent to which the outcome of future events may be controlled.

Information on completed cycles deals with highly probable cash flows and describes events that are beyond control and without future consequences. They measure, with some precision, past results in a known environment. Information about completed cycles is useful for predicting to the extent that knowledge about what has happened indicates what may happen.

Incomplete cycles have direct implications for assessing and controlling the future. Information about the expected outcome of incomplete cycles is useful for predicting, but the expected cash consequences are necessarily less certain than those realized in completed cycles.

Prospective cycles indicate the direction of enterprise activity. Although most amenable to control, prospective cycles involve the highest degree of uncertainty in terms of ultimate cash consequences.

Identification and measurement of the elements of completed and incomplete cycles require matching of the results of related transactions and other events. In the completed cycle, sacrifices are directly matched with the related benefits: costs of products sold are matched with the related proceeds. In the typical incomplete cycle, sacrifices (or benefits) are deferred for later matching with prospective benefits (or sacrifices): costs of unsold products are deferred until they can be matched with prospective sales proceeds. Identification of the status of earnings cycles provides a framework for relating or pairing transactions or other events.

Identifying Progress Toward Earnings Cycle Completion

The time required for the completion of cycles varies among and within enterprises and often extends beyond conventional reporting periods. Thus, the demands of periodic reporting cannot be satisfied solely by structuring financial information on the basis of completed cycle identification. For an earnings cycle which extends for more than one reporting period, progress

toward cycle completion sometimes should be recognized before the actual completion of the cycle.

The determination of whether recognizable progress toward cycle completion exists, and how to measure the extent of such progress requires an analysis of the underlying circumstances. When a cycle is not completed because further sacrifices and/or benefits remain to be realized, or when the effort is not completed, there may nevertheless be sufficient evidence to warrant recognition of progress toward completion of that cycle.

Activities under long-term construction-type contracts may fall into this category, as may manufacturing products to fulfill a firm sales order. Manufacturing products for stock would not usually represent recognizable progress towards cycle completion since realization of the benefit from inventory in stock is not sufficiently probable. Conditions such as the presence or absence of a sales order, the uncertainty of the market, or the effort required to dispose of the finished product should be considered in making this determination. In certain cases, however, the conditions may justify recognition of progress toward completion of the cycle.

Changes in the value of assets held for sale do not represent recognizable progress toward the completion of a cycle because external and unpredictable circumstances, such as changing attitudes in the marketplace, may affect prices before the assets come to market. Uncertainty as to the ultimate cash receipt exists and prevents recognition of any progress. Value changes also differ from recognized progress in the degree of management control and accountability. Nonetheless, information about changes in value may provide the best current indication of the outcome of the cycle.

Information to Be Presented in Financial Statements

Financial statements should present information useful for assessing earning power. But financial statements probably cannot present a single or unique measure of earning power or of the value of the enterprise. The value of an enterprise is based on individual assessments of its earning power. Therefore, since investor predictions and risk assessment are, in part, based on the information contained in the financial statements, it would be circular to reflect these composite predictions and assessments in the statements. However, management's evaluation of individual resources and obligations would be helpful to others.

Earnings in Financial Statements

Earnings as reported in financial statements have come to be, and in all probability will continue to be, the single most important criterion for assessing the enterprise's accomplishments and earning power.

The earnings of an enterprise over its lifetime are measured by the differences between the net cash resources at the end and at the beginning of its life, adjusted for distributions to owners, or contributions by them.

If one were able to foresee with certainty the amount and timing of all the cash flows during that lifetime, one would be able to assess all of the intermediate stages of enterprise goal accomplishment. Earnings could be precisely determined on an interim basis. But, of course, such foresight does not exist. Nonetheless, the concept of earnings, given certainty, is useful as an abstraction. The problem is to apply it in practice.

Further, if one could reduce the future cash flows to a single number at various times through an appropriate discounting process, earnings for a period could be determined by comparing changes in present value, as long as changes in the value of the monetary unit were adequately considered. This ideal is unattainable by any present direct measurement process. It may be asked whether periodic earnings in terms of present value changes can be approximated, acknowledging that presently known methods do not permit precise measurement. If they can, an advance could be made toward the ideal. But it is unlikely that present value changes can be approximated by direct measurement of the discounted future cash flows of individual enterprise resources, if only because of their interdependence. Actually, one practical approach to this ideal may be to measure the change in value of all individual resources, using the most appropriate valuation method for each.

In time, the resolution of various accounting problems as they relate to the ideal of measuring prospective cash flows—including new situations that will arise as business is conducted in new and different ways—should bring about more consistency and comparability within the enterprise and among enterprises. The extent to which progress will be made and the pace of the advance will no doubt be determined by several factors. One, of course, is the acuteness with which the ideal itself is formulated. Another is the development of reasonably objective measures of all resources. Still another, and one which should not be understated, is the advancement of general understanding of the meaning, purpose, and limitations of financial statements. In the final analysis, the ideal determination of earnings can be approached no faster than the increase in user confidence in accounting measures permits.

The determination of periodic earnings may develop in stages toward a methodology based on changes in discounted cash flows. At present, periodic earnings generally reflect only the results of completed earnings cycles plus the best estimates of measurable progress toward completion of particular incomplete cycles.

Changes in the value of resources that indicate the outcome of incomplete cycles may be introduced in various ways, at first as supplementary information. However, it seems reasonable to assume that, even in the long run, a distinction will have to be made between that portion of earnings resulting from completed cycles and recognizable progress toward the completion of incomplete cycles, and that portion of earnings arising from changes in value. This distinction is necessary because these different kinds of measures vary in the uncertainty of determining their ultimate impact on cash.

This view of earnings measurement assumes that users generally will want to make their own judgments about uncertainty.

It is not the purpose of a statement of accounting objectives to set forth specific guides or standards for measuring the value of a variety of resources. It is simply noted here that different value measures may serve some of the objectives described in this report. Determination of the value of particular resources and obligations should be tested in the context of such matters as whether the resource is to be sold, traded, or used in production—all, of course, in terms of the overriding objective of impact on earning power. Different approaches to value determination of particular assets and liabilities seem desirable, since no single valuation basis approaches the ideal in every instance.

Reporting and Communicating Success in Achieving Enterprise Goals—Nature of Information

The objectives of financial statements should set forth a basis for providing information helpful to users of financial statements. Accounting objectives should guide the development of standards for the treatment of classes of transactions and other events in financial statements. These standards, in turn, should lead to methods and practices for the preparation of financial statements.

The data selected for inclusion in financial statements should aim at providing information useful for assessing the impact of current developments on the earning power of the enterprise. Principal interest focuses on activities within the enterprise, that is, on transactions entered into or planned to generate earnings or enhance earning power. However, events outside the enterprise—such as changes in taxes, trade restrictions, technological innovations, and values of resources—also affect earning power. Financial statements should provide information for estimating the effects of both kinds of events.

Economic decision-makers need both factual and interpretive information—identified separately to the extent possible—about transactions and other events in order to assess uncertainty. Factual information can be measured objectively. Interpretive information is largely subjective and frequently cannot be easily quantified. Unfortunately, much information is neither purely factual nor purely interpretive, so that, as a practical matter, the distinctions between factual and interpretive information are not as precise as users would like them to be.

For example, an expenditure of, or a commitment to spend, $100,000 for inventory or plant and equipment represents factual information that can be reported without the need to make significant judgments or interpretations. But reporting that all or part of a $100,000 expenditure creates an asset rather than an expense requires a significant judgment about the extent of future benefits.

In summary, a judgment must always be made as to what information is selected for reporting. But once having made this judgment, factual informa-

tion is that information which requires minimal additional judgments or interpretations for reporting. Interpretive information, on the other hand, requires significant judgments on the part of the preparer.

In all reporting, the assumptions, interpretations, predictions, and estimations that underlie the preparer's conclusions should be set forth. The nature and extent of detail given in support of these conclusions is a matter of application. The test is whether the information presented enables users to make their own assessments of uncertain matters and of the conclusions of the preparer.

If facts and the results of interpretation are not distinguished, different users are not in a position to make judgments in light of their own different risk criteria. A statement of the amount of net earnings, for example, is the final result of a series of interpretations and conclusions by the preparer. Without factual information, users have little basis for assessing these judgments and for deciding whether the risk inherent in the activities of the enterprise is one they are willing to accept. Therefore,

> **An objective of financial statements is to provide factual and interpretive information about transactions and other events which is useful for predicting, comparing, and evaluating enterprise earning power. Basic underlying assumptions with respect to matters subject to interpretation, evaluation, prediction, or estimation should be disclosed.**

Based on the previous analyses of users' needs, their decision-making processes, and their interest in enterprise earning power and the impact of transactions and other events on earning power, the following can be concluded:

- Financial statements should emphasize information about transactions and other events that significantly affect enterprise earning power or changes in it. Such information should be stated in terms of actual or prospective cash impact and should facilitate comparisons.
- Financial statements should report both facts and interpretations about transactions and other events.
- Financial statements should assist in the assessment of the uncertainties with respect to the amount and timing of prospective cash receipts and disbursements.
- Financial statements should report on series of transactions and other events, including value changes, in terms of earnings cycles.

The Study Group concludes that these goals can be attained through financial statements' having the characteristics described in the following sections.

Statement of Financial Position

Assessing enterprise status at any point requires a statement of incomplete cycles. This statement would include much the same information contained in today's balance sheet or statement of financial position.

The statement of financial position should include two elements. First, it should include those assets and liabilities that identify cycle beginnings and endings, that is, the existing resources and obligations that represent realized benefits and sacrifices, e.g., cash; accounts receivable, whose collection is highly probable; and accounts payable, whose payment is highly probable.

Second, the statement should include the results of transactions and other events that are part of incomplete cycles. Information about *assets* (sacrifices for which potential benefits have not yet been realized) and *liabilities* (benefits for which sacrifices have not been made) can be used to assess the prospects for earning power at any given time.

Conventional statements of financial position have provided information on past sacrifices or benefits. Assets, with the exception of cash and accounts receivable, are quantified at their sacrifice value. Liabilities are quantified at their benefit value. Information about prospective benefits, prospective sacrifices, and prospective results of cycle completion is generally not provided.

Economic decision-makers, however, need information for predicting, comparing, and evaluating the outcome of incomplete cycles. That includes data about expected, as well as past, sacrifices and benefits when these differ significantly. The eventual realization of assets and satisfaction of liabilities involves varying degrees of uncertainty. Identifying the varying degrees of uncertainty would enable users to assess these cash consequences more effectively. The potential benefits of any assets arising from expenditures such as those for research and development and employee training may be so uncertain that such items should be segregated and reported separately and in greater detail, perhaps in a separate statement. Such treatment would emphasize their unique nature and would allow users to make their own judgments about potential benefits.

Statements of financial position that disclose past and prospective sacrifices and benefits would furnish information about both historical costs and current values. Various current value measurements could be used as indicators of the prospective benefits of assets and sacrifices for liabilities, and of the current sacrifice or benefit aspects of holding them. Each of the current value measurements represents a discounting of expected cash flows, either implicitly by the market (for exit values and current replacement cost) or explicitly by the preparer (for discounted cash flows). The discount rate used by the market or the preparer reflects a subjective assessment of the degree of risk involved. Thus, because he has his own risk preference, disclosure of the current values would be of most help to the user if the amounts of the expected cash flows and the discount rates are disclosed separately. It is, of course, impossible to provide both those components

for values determined by the market, but they can be made available when discounted cash flows are reported.

Historical cost is probably, for the present, the only reliable measure of the sacrifice incurred in obtaining assets and the only measure of the benefit realized by incurring liabilities. Value measures probably provide the best current indication of the outcome of incomplete cycles. The choice among these value measures will vary depending on circumstances. Therefore,

> **An objective is to provide a statement of financial position useful for predicting, comparing, and evaluating enterprise earning power. This statement should provide information concerning enterprise transactions and other events that are part of incomplete earnings cycles. Current values should also be reported when they differ significantly from historical costs. Assets and liabilities should be grouped or segregated by the relative uncertainty of the amount and timing of prospective realization or liquidation.**

Changes in stockholders' equity should be reported either in the statement of financial position or separately. Changes in values reflected in successive statements of financial position also should be reported.

Statement of Earnings

In attempting to provide information for predicting, comparing, and evaluating enterprise earning power, the statement of earnings might reflect solely the results of completed earnings cycles. That would provide relative certainty as to ultimate cash conversion, but it would not include other information useful for assessing earning power.

Even if accounting earnings were confined to the results of completed cycles, measurement problems would still exist. For example, accounting for long-lived assets requires allocations of sacrifices or benefits over periods of time.

Another measure of earnings would be determined by the changes in value of resources and obligations during a period and would be shown as a single amount. This single amount would include the results of cycles completed during the period, estimates of recognizable progress toward completion of incomplete cycles, and, in addition, changes in the potential results of incomplete cycles as they are indicated by value changes. Information about varying degrees of uncertainty would then be combined in a single measure of earnings. However, a presentation of earnings showing each category separately, as a subtotal, would assist users in assessing the degree of uncertainty associated with each category.

In establishing a useful concept of earnings, a trade-off is necessary between minimizing uncertainties and reporting earnings on a reasonably inclusive basis. The essential question then becomes whether earnings should be measured only in terms of the results of completed cycles or in

terms which also include estimates of progress toward cycle completion and recognition of value changes. The completed cycle approach emphasizes only the reasonable certainty of cash realization and stresses the importance of relative certainty in measuring the periodic performance of an enterprise. But only the simplest of cycles can be identified as completed. Users who make judgments of enterprise progress require information about a complex amalgam of data about incomplete and completed cycles, as well as the probable impact of value changes.

This broader approach to earnings measurement emphasizes prospective cash flows but also covers varying degrees of uncertainty of realization. A pure completed cycle concept of earnings is too limiting because it excludes complex factors that bear importantly on prediction. An approach that endeavors to strike a balance between these conflicts emerges as a more useful means for users to fulfill their own needs. Therefore,

> **An objective is to provide a statement of periodic earnings useful for predicting, comparing, and evaluating enterprise earning power. The net result of completed earnings cycles and enterprise activities resulting in recognizable progress toward completion of incomplete cycles should be reported. Changes in the values reflected in successive statements of financial position should also be reported, but separately, since they differ in terms of their certainty of realization.**

For some time, there has been consistent demand for a single earnings figure. Members of the Study Group disagree on whether value changes that meet the qualitative criteria discussed in this report should be included in earnings. Some believe the objective should be to reflect current value changes in earnings. Others believe that inclusion of unrealized value changes in earnings may be desirable but is not now practicable. Still others believe that their inclusion is neither desirable nor practicable.

Statement of Financial Activities

Economic decision-makers need various types of information to assess earning power. They need information about earnings and about financial position. Both of these measures are affected by judgments about the completion of incomplete cycles. These judgments, in turn, are based in part on interpretations of the significance of various events. Preparers of financial statements must make these interpretations and the attendant estimates. The statement of earnings—showing progress and results—and the statement of financial position—showing status—necessarily combine facts and estimates.

Yet another presentation is also useful: a *statement of financial activities* summarizing transactions, that is, those exchanges to which the enterprise was party during the period. An important purpose of the statement is to present an ordered array of financial activities to emphasize factual informa-

tion about transactions, so that the user can make his own interpretation of their significance.

The statement of financial activities should disclose only those activities that are presumed to have significant cash consequences. They should be so ordered as to stress such functional activities as purchasing, manufacturing, selling, leasing, and financing. The consequences of many of the activities are reported either in the statement of earnings or in the statement of financial position, and to that extent, all three statements might articulate. However, this statement of financial activities may disclose events not described elsewhere, such as purchase commitments and changes in sales backlogs, but is not intended to disclose other events, such as significant value changes.

Use of a statement of financial activities raises an important question: whether to emphasize changes in cash itself or changes measured in terms of a highly probable effect on cash. Each approach has unique advantages. The former stresses cash flow, the latter the substantive aspect of probable cash flow. The Study Group views the latter as being more significant and helpful for assessing cash consequences.

Accordingly, transactions that establish highly probable receipts and disbursements of cash should be emphasized in the financial activities statement. For example, in most cases, the statement should report sales of product rather than collection of the related receivable. Similarly, it should report purchases of product rather than payments of resulting obligations. Sales, purchases, other acquisitions, and similar activities should be grouped to show their overall effect on the change in net liquid assets (cash, plus highly probable cash receipts, less highly probable cash disbursements).

The statement should also disclose acquisitions of long-term assets, incurrence of long-term debt, capital contributions and distributions and related transactions, as well as purchase commitments, lines of credit, sales backlog, leases, and other activities with likely cash consequences.

An important difference between the statement of earnings and the statement of financial activities is in the way they report the relationship between sacrifices and benefits. The statement of earnings reports benefits and related sacrifices. Since these may occur either in the same or in different periods, they must be allocated to measure earnings. The statement of financial activities, on the other hand, reports benefits received and sacrifices made during the period. No attempt is made to relate these sacrifices and benefits to the earnings process. Therefore, the statement of financial activities does not involve allocation of any kind. With the exception of estimating highly probable cash effects, the statement of financial activities includes no other estimates or interpretations of the significance of events. Thus,

> **An objective is to provide a statement of financial activities useful for predicting, comparing and evaluating enterprise earning power. This statement should report mainly on factual aspects**

of enterprise transactions having or expected to have significant cash consequences. This statement should report data that require minimal judgment and interpretation by the preparer.

Desirable Features of All Financial Statements

Each of the financial statements should be structured to enhance the user's ability to assess the following:

- The extent to which sacrifices and benefits vary over time and among themselves, such as differentiation between fixed and variable expenses.
- The extent to which sacrifices and benefits vary in relation to changes in the industry and the economy.
- The extent to which the occurrence of sacrifices and benefits, or their allocation to time periods, is discretionary or arbitrary. Examples are contributions, unusual research expenditures, or the recognition of gains or losses whose timing can be controlled.
- The extent to which sacrifices and benefits are unusual or infrequent and therefore require special consideration for predicting, comparing, and evaluating.
- The extent to which sacrifices and benefits pertain to various lines of activity of the enterprise.

Communicating in Single Numbers and Ranges

Accounting conventionally has expressed information in terms of single numbers. For example, inventory and earnings are expressed only in terms of single dollar amounts. Restricting measurements in this manner has several limiting effects.

The range of possible values around a single reported amount may be wide or narrow depending on what is being described and on the precision and reliability of the measuring process. Measurements in terms of single numbers that do not indicate possible ranges and dispersions pose problems in describing events subject to uncertainty. Some transactions, by their very nature, can be quantified with reasonable precision by using a single number. However, the potential of a transaction (that is, the future benefit or sacrifice) may be less subject to precise measurement with single numbers.

The prospective impact on earning power of any transaction or other event is often difficult to ascertain. For example, disbursements for advertising a new product, while representing a discernible sacrifice to the enterprise, may not cause the market to accept the product. The deferral of such disbursements may not be justified. The impact on earning power of these disbursements may be communicated most effectively by indicating the preparer's judgment of the possible range of results.

Many economic decision-makers would prefer simple, not complex, answers, but simple answers may not serve them as well as complex ones.

Single numbers supplemented by ranges and investments grouped by relative risk may be more complex, but they may also communicate more accurately the imprecision involved in making judgments. For example, investments in two securities, each of which having at one time the same market price, say $40 a share, may seem to be identical. But security *A* may have traded in a range of $38-$42, while security *B* may have traded within the range of $20-$60. Describing both as $40 investments and reporting total investments as $80 omits an important fact.

To satisfy the individual preferences of users for predicting and controlling the impact of current events on enterprise earning power, some apparently simple quantifications should be supplemented to represent their actual complexities by disclosing ranges of precision, reliability, and uncertainty.

CHAPTER 6

Financial Statements— Historical Cost and Value Considerations

The Study Group believes that the objectives of financial statements cannot be best served by the exclusive use of a single valuation basis. The objectives that prescribe statements of earnings and financial position are based on the user's need to predict, compare, and evaluate earning power. To satisfy these information requirements, the Study Group concludes that different valuation bases are preferable for different assets and liabilities. That means that financial statements might contain data based on a combination of valuation bases.

The four valuation bases that have been advocated are these:

Historical Cost: A valuation basis quantifying assets and liabilities in terms of original or allocated acquisition prices. Historical cost earnings represent the difference between realized revenues and expenses, with recorded sacrifices being interpreted as expense when they will produce no future benefits. Changes in values of assets and liabilities generally are not reflected in net assets or in earnings, except for downward adjustments of certain assets.

Exit Values: A valuation basis quantifying assets and liabilities by the amounts that would be received or paid currently as a result of nondistress liquidation. Exit value earnings represent the change in the exit value of net assets during a stated period, excluding capital contributions and withdrawals. Exit value measurements in statements of earnings do not directly describe revenues and expenses.

Current Replacement Cost: A valuation basis quantifying assets (and usually liabilities) in terms of present prices for items equivalent in capacity or service. Earnings computed by current replacement costs are the difference between realized revenues and expenses, stated in terms of sacrifices that would be incurred currently. Earnings computed by this method also include, in a separate category, changes in the replacement costs of assets (and possibly liabilities).

Discounted Cash Flows: A valuation basis quantifying specific assets and liabilities, or the enterprise as a whole, by discounting all expected cash flows at a rate reflecting both time values and risks. Discounted cash flow earnings represent the change in the present value of future cash flows over time, with periodic revision of expectations, but without the traditional description of revenues and expenses.

The specific combination of valuation bases to be used is an implementation issue. The decision should give appropriate consideration to the suggested financial statement objectives. Each of the valuation bases should be analyzed in terms of the stated objectives.

One objective proposes that the statement of financial position provide information about incomplete earnings cycles. Information about both the sacrifice and the benefit aspects of each asset and liability should be reported when they differ significantly from each other.

Another objective states that the statement of earnings should provide

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The following table attempts to provide an indication of the relationship of each valuation basis to these requirements. Each measurement basis is described in the following table in terms of whether it tends to be directly helpful, indirectly helpful, or not helpful in fulfilling information requirements. The characterizations in the table do not attempt to be the definitive determination of the usefulness of these valuation bases. The table merely indicates how such an analysis should be structured in terms of financial statement objectives.

	Valuation (or Measurement) Basis			
Information Requirements	Historical Cost	Exit Values (A)	Current Replacement Costs	Discounted Cash Flows (B)
1. Actual sacrifice for assets/ actual benefits of liabilities	Directly helpful	Not helpful	Not helpful	Not helpful
2. Potential benefit of assets/ potential sacrifice for liabilities	Not helpful	Directly or indirectly helpful	Indirectly helpful	Directly helpful
3. Measurement of completed cycles and recognizable progress toward the completion of cycles	Directly helpful	Not helpful	(C)	Not helpful
4. Measurement of value changes that provide the best current indication of the outcome of incomplete cycles	Not helpful	Directly or indirectly helpful	Indirectly helpful	Directly helpful

A. Exit values are directly helpful for estimating the outcome of incomplete cycles of those assets and liabilities intended for current sale or liquidation. For some assets and liabilities, exit values, at best, can only provide indirect indications of potential benefits and sacrifices. In certain circumstances, exit values may not provide any indication of prospective benefit or sacrifice.

B. Discounted cash flows are usually applicable to groups of assets and liabilities. Cash flows are the result of complex interactions and therefore are not relevant for the measurement of most specific assets and liabilities.

C. If the measurement of completed cycles seeks to divide earnings into (1) the results of enterprise activities, and (2) value changes, then current replacement costs are directly helpful. If the measurement of completed cycles is confined to measuring cash consequences only, current replacement costs are not helpful.

information about completed earnings cycles, recognizable progress toward completion of cycles, and value changes. Still another proposes that information be disclosed that will be useful for judging management effectiveness.

Taking these stated objectives as a whole, the measurement bases of statements should be tested in terms of whether they produce information about the following:

- Actual sacrifice for assets and actual benefit of liabilities.
- Potential benefit of assets and potential sacrifice for liabilities.
- Measurement of completed cycles and of recognizable progress toward completion of cycles.
- Measurement of value changes that provide the best current indication of the outcome of incomplete cycles.

The material set forth in the table may be restated in this manner:

- Discounted cash flow quantifications, while directly relevant to prediction, are often difficult to assign to individual assets and liabilities. The discounted cash flow method may be most useful for measuring potential benefits for groups of related assets such as operating subsidiaries and divisions for which no independent market value exists.
- Historical cost is appropriate for describing a past aspect of all assets and liabilities, that is, the sacrifices incurred to acquire assets and the benefits received from incurring liabilities.
- Current replacement cost may be the best substitute for measuring the benefits of long-term assets held for use rather than sale. Current replacement cost may be particularly appropriate when significant price changes or technological developments have occurred since the assets were acquired.
- Exit value may be an appropriate substitute for measuring the potential benefit or sacrifice of assets and liabilities expected to be sold or discharged in a relatively short time. For many assets and liabilities, exit values and current replacement costs may be substantially the same. In such cases, the ease and cost of application should be considered. These valuation bases also may be useful for assessing alternative courses of action (opportunity costs). Exit values measure the opportunity to sell assets or discharge liabilities that continue to be held. Current replacement costs measure opportunities forgone.

The quantifications produced by applying each of these valuation bases vary in reliability, precision, and cost of application. These factors should be weighed in the process of choosing the appropriate basis or combination of bases for fulfilling financial statement objectives as they relate to each of the assets or liabilities under consideration.

CHAPTER 7

The Predictive Process and Its Relationship to Objectives

The predictive process is central to many of the objectives set forth in this report. All economic decisions look to the future. Since economic decision-makers cannot know the future, they must approach it by looking to the past and the present. For this reason, financial statements that provide information about the past and the present are useful for making predictions on which to base economic decisions.

Conventional Financial Statements and Judgments About the Future

Preparers of present financial statements consider what, if any, future benefits or sacrifices will result from related past sacrifices or benefits. For example, in preparing financial statements, they estimate the timing and amount of receivable collections, the useful life of plant and equipment, the likelihood of recovering deferred costs, and the potential liability from product failures. In making these judgments, the principal concern is that the amounts shown in the statement of financial position adequately consider adverse consequences.

Users often misunderstand the judgments that are required to quantify many financial statement items as well as their level of accuracy. Because the presentation of financial statements implies a high degree of precision, users do not realize that what seems precise often, in fact, is not. In a conventional statement of financial position, cash may be the only asset that can be stated with a relatively high degree of precision and reliability. The amounts shown for all other assets, as well as some liabilities, are less precise.

Information Useful for Assessing the Future

Forecasts and projections deal exclusively with estimates and expectations of the future. Such data may be reported as a statement or in narrative form. Users of financial statements look to the past as one indicator of the future. In many instances, however, the past may not be a good indicator of the future, especially for enterprises affected by changes in technology, in industry conditions, or by acquisitions or disposals. Management changes that produce new policies or philosophies may also make the future significantly different from the past. For such enterprises, the past

often does not indicate the future, and if presented alone, may lead to incorrect inferences.

Financial Forecasts—Accuracy and Utility

Forecasting is clearly an integral part of every economic decision. But that does not answer the question of whether management forecasts ought to be published. The answer may well depend on their relevance and reliability. For example, a forecast of the factor most relevant to investors, the future market price of a stock, may be least accurate. The forecast or projection of the most readily determinable factor, for example, next year's depreciation, may be least useful for decisions. In developing financial statement objectives, the Study Group is concerned with making information more useful, while preventing the introduction of potentially inaccurate or unreliable data. This concern is particularly acute with respect to the publication of forecasts, whether as formal statements or as informal parts of management's presentations.

Publication of explicit forecasts of enterprise activities may well fit the objectives of financial statements. They may make financial statements more comprehensive and useful; but, the uncertainty inherent in forecasting may diminish the usefulness of the information.

Forecasts and projections are often communicated informally in speeches, press releases, president's letters, and in other ways. Recently, several publicly held companies have published formal forecasts. The issue here is not whether forecasts should be made, but whether they should be included in financial statements.

The important consideration is not the accuracy of management forecasts themselves, but rather the relative accuracy of users' predictions with and without forecasts in financial statements. Forecasts should be evaluated in terms of whether they make financial statements more or less useful for predictive purposes. If users' estimates of the future are enhanced, forecasts should be published. Thus,

> **An objective of financial statements is to provide information useful for the predictive process. Financial forecasts should be provided when they will enhance the reliability of users' predictions.**

Reporting Forecasts or Projections

Users of financial statements need information to assess management's interpretations of events and their consequences. Users also need to know at least the major assumptions underlying management's interpretations. Then they can evaluate those interpretations in terms of their own criteria for risk and return. Otherwise, these interpretations lose much of their utility.

This need is even more critical for forecasts. Just as the user should consider the prospect of past trends continuing into the future, he also should evaluate any explicit forecast of the future. Management cannot consider the risk and return criteria of each user in making its forecasts. Therefore

forecasts—along with all other financial information—should be presented with their significant underlying assumptions, so that each user can evaluate them in the context of his own needs. The underlying assumptions supporting forecasts, however, should not be presented in such detail that they affect adversely the enterprise's competitive position.

The use of ranges to supplement single numbers may be appropriate in forecasts. The limits of the range would indicate the uncertainty inherent in the forecast. A range of numbers would also remind users that they are dealing with estimates that should not be considered to be more precise than intended.

However presented or displayed, forecasts or projections should be updated periodically and ultimately compared with actual accomplishments as reported in financial statements. Accordingly, the preparer should explain, formally or informally, significant differences between the original and revised forecasts and between forecasts and actual results.

CHAPTER 8

Objectives of Financial Statements for Governmental and Not-for-Profit Organizations

The primary goal of commercial enterprises is to increase monetary wealth so that over time they can return the maximum amount of cash to owners. This is not the central goal of governmental, charitable, educational, and other eleemosynary organizations. Nonetheless, financial statements of not-for-profit organizations should provide information that serves users' needs.

Decisions About Governmental and Not-for-Profit Organizations

Many of the aspects of a decision to allocate funds to government agencies, to donate to a hospital, university, or church, or to approve or reject a tax referendum are in many ways like aspects of the decision to invest in securities. In making any of these decisions, a person contemplates making certain sacrifices in the hope of realizing particular benefits. For example, funds are allocated to government agencies to obtain certain social benefits. Contributions to a hospital may be made with the hope of improving health care or discovering cures for disease. Further, monetary sacrifices made to such organizations by individuals and private enterprises may produce private beneficial consequences. Improving the health care or educational level of a community, for example, can help develop a more efficient work force for private enterprise in that community.

One basic similarity of commercial and not-for-profit organizations is that decision-makers look to them as a means to attain their personal goals. Thus, if an individual is interested in reducing poverty or curing illness, he will usually make a donation to a research organization rather than attempt to solve these problems himself. The donation is made in anticipation of progress. If the donor does not feel that progress is being made, he can stop his contributions.

To estimate the probable benefits resulting from each decision, decision-makers should attempt to evaluate the organization's ability to achieve goals that conform to their own. They may also attempt to influence the goals of the organization. For instance, a donation restricted to a specific purpose exerts influence over an organization's activities.

As with commercial enterprises, decision-makers are interested in predicting, comparing, and evaluating benefits and sacrifices in terms of amount, timing, and related uncertainty, even though they seek nonmonetary benefits. These benefits are not easily quantified, but the decision process is essentially the same.

Objectives of Financial Statements for Not-for-Profit Organizations

Since the goals of governmental and not-for-profit institutions are primarily nonmonetary, the indicators of earning power in commercial enterprises have limited value for assessing their performance. More useful indicators are those based upon the not-for-profit organization's principal goal, such as its ability to achieve national security, to reduce poverty, or to encourage research. But these are more difficult to measure and communicate in monetary terms, because the goals themselves are qualitative, not monetary. Goals vary widely and, when identified, are frequently difficult to measure. Useful measures of performance for one organization may be meaningless for another. Still, performance for each must be measured.

The measurement of potential or actual benefits resulting from sacrifices by not-for-profit organizations is especially difficult. Information about the number and cost of patient-days provided by a hospital is of limited value; consideration must be given to the quality of the care. The numbers of credit courses completed or degrees granted by a university means little without reference to the quality of that education. In government, spending on poverty programs or agricultural supports should be assessed in terms of changes in the poverty level or improvement in the agricultural economy. The cost of military aircraft—or, in fact, the efficiency of production—should be viewed in the context of the nation's defense strategies.

Still, the objectives of the financial statements of commercial enterprises can provide broad guidelines for the development of objectives in the not-for-profit sector. They can offer useful distinctions about the decision-making process and users' needs that deserve attention in any effort to develop financial statement objectives for not-for-profit organizations.

The evaluation of the attainment of long-range goals of a commercial enterprise prior to its dissolution provides a useful pattern for the evaluation of governmental and eleemosynary organizations. Financial statement users need information for assessing

Past goal attainments of the organization.

The status of present efforts to attain goals.

The probability of future goal attainment.

Similarly, significant assumptions underlying judgments, interpretations, approximations, and probabilities for all information should be disclosed so that users can apply their own judgments and interpretations.

Managers of government and eleemosynary organizations are also ac-

countable for their performance and goal attainment. Thus, reporting on such accountability is as important for not-for-profit organizations as it is for commercial enterprises. Consequently,

> **An objective of financial statements for governmental and not-for-profit organizations is to provide information useful for evaluating the effectiveness of the management of resources in achieving the organization's goals. Performance measures should be quantified in terms of identified goals.**

CHAPTER 9

The Relationship of Enterprise Goals To Social Goals

This report is primarily concerned with information in financial statements that is useful for making economic decisions. It focuses on information to be used in predicting the monetary goal attainment of enterprises. This emphasis was adopted not because social goals are less important than economic goals, but rather because our social and economic system assumes that the pursuit of private goals generally tends to fulfill the social ones. The objectives structure of this report, while primarily directed toward private goals, is intended to apply at least indirectly to social goals as well.

Many laws are intended to encourage and protect private enterprise, the investment process, and free markets in the belief that such institutions advance the common good. Similarly, the accounting objectives in this report are intended to produce financial information that will facilitate decisions that advance the common good.

Our society not only encourages free enterprise but also adopts laws to curb, limit, and control free enterprise when it does not serve social goals. The information needs of government and regulatory agencies that monitor, regulate, and control commercial enterprises have not been explicitly discussed for two reasons. First, these agencies have or usually can obtain the authority to demand whatever information they need. Second, and more importantly, the suggested objectives for information that can be used to predict, compare, and evaluate enterprise goal attainment also can be used in the public sector.

While private and social goals are to a large degree complementary, they interact in several ways that should be considered.

Reciprocal or Direct Interactions

All commercial enterprises and, in fact, all individuals and groups use resources provided by society, and they pay for them through taxes and other government levies. An enterprise gets police and fire protection, national security, and other social benefits. In exchange for these social benefits, the enterprise makes tax payments and, therefore, incurs private costs. Thus, payments by the enterprise to society constitute a reciprocal or direct relationship in which the enterprise enjoys benefits and incurs sacrifices.

Nonreciprocal or Indirect Interactions

An enterprise may make sacrifices to obtain indirectly some of the benefits that accrue to society as a whole. Examples of these are charitable contributions, special training for minority groups, and voluntary ecological improvements. These activities represent sacrifices that may not yield commensurate benefits in the short run; although the activities for which such contributions are made do in many cases benefit the enterprise. For example, contributions to charity may produce a better business environment, improve the company's image in the marketplace, and help to attract qualified employees.

The impact on earnings of these indirect benefits is often difficult to establish. The sacrifices incurred represent current outlays and are reported presently in financial statements. The central reporting problem is how and in what way these sacrifices can be related to benefits.

A similar problem exists in reporting those enterprise activities which require sacrifices from those who do not benefit. Activities causing pollution are an example. A company manufactures its product and pollutes the air or water in the process. In this case, the company receives a benefit—usually lower cost—as a result of sacrifices by others. This benefit is reflected in financial statements, but the resulting social costs are not. Legislation that aims to prevent pollution often converts these social costs into private costs by requiring that manufacturers install pollution control equipment.

The Measurement and Reporting of Social Interactions in Financial Statements

In the case of reciprocal or direct interactions, both the sacrifices and the benefits accrue to the reporting company. Since they affect its earning power, they should continue to be part of its regular reporting process.

Nonreciprocal or indirect interactions present both measurement and reporting problems. An enterprise that voluntarily incurs monetary costs to attain social goals generates two significant effects. On the one hand, current earnings of the enterprise may fall as monetary sacrifices are incurred. On the other, some nonmontetary social benefit—such as cleaner air—is sought and may be gained. While reduction of present earnings should be reported in monetary terms, the measurement and communication of the related social gain and the presumed intangible benefit to the enterprise may be impossible to quantify.

The sacrifices incurred to achieve social goals can be separated and described—and so can the benefits, but most likely not in dollars. These sacrifices might include the amounts donated to a hospital or spent in hiring and training handicapped people. The results can be reported in terms of additional hospital bed capacity or the number of handicapped employed. To go further in reporting the relationship between private and social sacrifices and benefits is difficult, because the sacrifice is largely monetary and the related benefit is mainly nonmonetary.

An equally difficult reporting problem arises when an enterprise's activities impose a cost on society. The notions of accountability and corporate responsibility imply the need for disclosure of the consequences of such activities; but identifying, measuring, and reporting their consequences without standards and guidelines is troublesome. Only society—through laws and regulation—can identify what it considers a cost or sacrifice. And only society can determine the extent to which it will absorb such costs or force enterprises either to modify their activities to eliminate social costs or else to pay for them. In these ways, social costs become private monetary costs that affect enterprise earnings and earning power.

Even when society has not yet taken action, some enterprises may choose to report activities that result in social costs. Users can assess those activities in terms of probable cost in relation to enterprise goals. When this cost is identified by society, there is a probability that the resulting action will affect the enterprise's earning power. Thus,

> **An objective of financial statements is to report on those activities of the enterprise affecting society which can be determined and described or measured and which are important to the role of the enterprise in its social environment.**

CHAPTER 10

Qualitative Characteristics of Reporting

Information contained in financial statements and in other reports of enterprise activity should possess certain characteristics to satisfy users' needs. Though these qualities may appear obvious and are presumed to be implicit in any intelligent reporting of information, nevertheless they are significant.

Relevance and Materiality

Relevance is, of course, inseparable from the concept of purposeful information. Financial accounting as a system of identifying and summarizing financial information is intended to help users make informed economic decisions. Information that does not bear on the problems for which it is intended simply is not useful, regardless of its other qualities.

Information should be disclosed in financial statements when it is likely to influence the economic decisions of the users of financial statements. Information that meets this requirement is material. Considerations of materiality are necessarily judgments. These judgments should relate to the significance of the information and its impact on users' economic decisions.

Since each component of financial statements provides information, judgments of materiality should be applied to each component as well as to aggregates and therefore should not be used to justify offsets.

Form and Substance

The guidelines for reporting information should be expressed so that substance, not form, governs. The Study Group, in framing definitions and objectives, has attempted to follow this principle. For example, earnings cycles are defined in terms of highly probable cash receipts and disbursements, rather than actual cash receipts and disbursements. This definition emphasizes substantive information concerning the probabilities of cash flows rather than the actual receipt or disbursement.

Similarly, the test for realization of sacrifices and benefits stresses probabilities rather than a formal event such as a sale. The definition of assets also highlights the substantive question of the presence of future benefits, regardless of the formality of ownership rights. The substantive economic characteristics, not the legal or technical form, should establish the accounting for transactions and other events. For example, this subordination of legal formality may affect the accounting for transactions between affiliated or related parties.

Reliability

Reliability varies with the nature of the information. For example, certain information presented about plant and equipment may be less reliable than certain information about current assets because of differences in uncertainty of realization. The most reliable information, however, may not be the most important in terms of the user's assessment of an enterprise's earning power.

Often, the preparation of financial statements requires technical skill and the exercise of judgment before all possible evidence is available. While later occurrences may not impugn earlier judgments, they may cause users to question those judgments. The objectives of separating fact from interpretation and of disclosing uncertainties and assumptions should increase the value of financial statements by indicating the inherent differences in reliability attached to various pieces of information.

The requirement that accounting information should be reliable does not imply that the information can possibly approach 100% accuracy. The reliability of financial statement information is affected not only by uncertainties inherent in the subject matter, but also by the degree of precision of the measurement process.

Precision to the degree where a reported value is identical to a "true" value is impossible to attain. Moreover, the attainment of high degrees of precision is not likely to be justifiable economically. Thus, accounting measurements, like others, may be subject to error. A continuing source of misunderstanding about accounting information and measurements is the tendency to attribute to them a level of precision which is not practicable or attainable. Users of financial information should be informed about data limitations and the magnitude of possible measurement errors. Financial statements should not be presented to imply a misleading degree of precision or reliability.

Freedom From Bias

Preparers and users, borrowers and lenders, buyers and sellers, special interest groups, and others have primary interests in financial statements. While any information affected by judgments necessarily has some bias, there should be no purposeful bias favoring any group. Absence of bias, which may be characterized as neutrality and fairness, has long been recognized in accounting, although the perception of what is neutral and fair has changed with the times and the needs.

In financial statements, avoiding bias which possibly benefits the interests of one group at the expense of another requires that the application of conservatism be carefully considered. Conservatism for its own sake may actually introduce bias. Confining financial statement representations to the results of transactions and other events for which substantial evidence exists and recognizing the varying degree of uncertainty would seem to aid in avoiding bias.

Degrees of uncertainty in accounting information are not disclosed at present. Instead, to avoid possible adverse consequences and to counter

possible management bias, the most conservative among alternative accounting treatments has generally been favored. Thus losses, but not gains, tend to be anticipated.

If financial statements do communicate information about varying degrees of uncertainty, about the judgments made and the interpretations applied, and about the underlying factual information, then the impact of surprises—pleasant or unpleasant—will diminish greatly. This should result in a substantial lessening in the belief that conservatism is essential.

Comparability

The essence of economic decisions is choice among possible courses of action. Choice requires awareness of the opportunities offered by alternatives. Financial information should facilitate the comparisons needed to make investment and other decisions.

The diversity of operations and of management viewpoints among independent business enterprises complicates the task of comparing financial reports. Comparability means to have like things reported alike, and unlike things reported differently. But achievement of that purpose is often elusive. The very existence of different accounting practices for describing essentially similar activities may be partly explained by the absence of explicit financial statement objectives. It was difficult to evaluate available practices in terms of which one best achieved reasonable objectives. One reason for financial statement objectives is to guide the development of accounting standards that will increase the ability to make comparisions.

Information about both the sacrifice and the benefit dimensions of assets and liabilities and about value changes—in addition to reporting the results of completed earnings cycles including recognizable progress toward cycle completion—should reduce the persistence of certain alternative accounting practices. Devices such as Lifo for inventory accounting represent an attempt to modify historical cost data so that current value information is reflected in earnings. Such attempts often result in statement of financial position values differing from current values, whatever desirable effects they may have on reporting of earnings. Pursuit of the financial statement objectives suggested by this Study would remove the need to adjust historical cost data for such purposes, thereby reducing allowable alternatives and increasing comparability. Reducing allowable alternatives in turn serves to lessen the opportunities for financial statements to reflect purposeful management bias.

Comparability is weakened if uncertainties, which vary significantly among companies and industries, are submerged or obscured. No accounting system can be devised that would lead all preparers to assess uncertainties alike; each will have independent estimates of risk and return. For example, the ultimate benefit of a sacrifice for research may be assessed differently by the managers of two similar research projects. With information that facilitates interpretation, users are able to compare and assess the results of similar transactions and other events among enterprises. Classifying information by relative risk based on assessments of uncertainties should

permit the user to compare information from many enterprises and make decisions more effectively within the context of his own risk preferences.

Comparability among companies most likely will be more attainable within an industry than between industries. Given the development of financial statement objectives, however, industries can establish standards that serve users' information needs and also provide comparability. Choices between alternatives can then be based on the economic substance of what is measured and reported rather than out of a desire to produce a particular financial statement result.

Consistency

Consistency of method over time is a valuable adjunct to comparability. The needs of users of financial statements may be expected to change, which will produce a need for changed objectives and for changed accounting standards. As better techniques are developed, accounting methods will also change. To provide continuity, it will be necessary to present results of both old and new methods for a time. The desire for consistency should not become an obsession that impedes progress. When information indicates that the current presentation is inappropriate, a new presentation should be adopted. But until that happens, consistency should be observed meticulously.

Understandability

Accounting information should be presented so that it can be understood by reasonably well-informed, as well as by sophisticated, users. In effect, presenting information understandable only to sophisticated users establishes a bias. Investors with means to do their own research already have an advantage over others. The form and content of financial statements should not add to this advantage.

Increasing understandability of financial information is not a matter of mere simplifying. Not all complexities can be made simple by describing them simply. Understandability requires that information be expressed as simply as permitted by the nature and circumstances of what is being communicated.

No valid users' needs should be ignored. Information that can be understood, and is needed, by sophisticated users should not be diluted to eliminate what less able users cannot understand. Instead, it should be ordered and arrayed to serve a broad range of users. Nor should accounting information be limited only to the interests of the average investor.

The qualitative characteristics of financial statements, like objectives, should be based largely upon the needs of users of the statements. Information is useless unless it is relevant and material to a user's decision. Information should be as free as possible from any biases of the preparer. In making decisions, users should not only understand the information presented, but also should be able to assess its reliability and compare it with information about alternative opportunities and previous experience. In all cases, information is more useful if it stresses economic substance rather than technical form.

CHAPTER 11

A Summary of Objectives Of Financial Statements

In the development of objectives of financial statements, the Study Group has attempted to identify and evaluate the desirable goals of the financial accounting process.

Accounting is not an end in itself. As an information system, the justification for accounting can be found only in how well accounting information serves those who use it. Thus, the Study Group agrees with the conclusion drawn by many others that

> **The basic objective of financial statements is to provide information useful for making economic decisions.**

In satisfying this objective, accounting should serve the goals of both the private and public sectors of the economy. By fulfilling the information needs of those in the private sector who make economic decisions, accounting assists in a more efficient allocation of resources, thus contributing to the attainment of broad social goals.

Users' needs for information are not known with any degree of certainty. The specific role financial statements play in the economic decision-making process has not been identified. This Study is therefore dependent upon certain assumptions which are supported by its research:

- Users of financial statements seek to predict, compare, and evaluate the cash consequences of their economic decisions.

- Information about the cash consequences of decisions made by the enterprise is useful for predicting, comparing, and evaluating cash flows to users. (If the value of the unit of measure is unstable, that is, if inflation or deflation is so great that direct cash consequences are no longer comparable, such circumstances should be recognized in the financial statements.)

- Financial statements are more useful if they include, but distinguish, information that is primarily factual, and therefore can be measured objectively, from information that is primarily interpretive.

The objectives of financial statements developed in this Study are in-

tended to follow logically from these assumptions.

Some users of financial information often have access to much more information than is available to users of general purpose financial statements. Therefore, users who ordinarily rely on financial statements alone may be served most by developing accounting objectives. Financial statements should meet the needs of those with the least ability to obtain information and the needs of others as well. Consequently,

> **An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.**

Most economic decisions involve a sacrifice (something given or used up) and a benefit (something received). Creditors and investors are concerned with the ability of the enterprise to generate cash flows to them and with their ability to predict, compare, and evaluate the amount, timing, and related uncertainty of these future cash flows. Therefore,

> **An objective of financial statements is to provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows to them in terms of amount, timing, and related uncertainty.**

The primary goal of every commercial enterprise is to increase its monetary wealth so that over time it can return the maximum amount of cash to its owners. Economic decision-makers need information about the enterprise's degree of success periodically before dissolution, because they make decisions every day. A fundamental purpose of accounting is to provide interim measures of enterprise progress. Accounting earnings should measure such progress. They should recognize the notion of economic better-offness, but should be directed specifically to the enterprise's success in using cash to generate maximum cash.

Given appropriate financial information, the decision-maker uses his judgment to evaluate the enterprise's potential. This judgment aims at estimating the enterprise's ability to be better off, to generate more cash, and to have earnings convertible into cash at some future date. This ability is the enterprise's earning power. Therefore,

> **An objective of financial statements is to provide users with information for predicting, comparing, and evaluating enterprise earning power.**

An enterprise is accountable for its actions, or inactions, in discharging a wide range of responsibilities. Accountability involves the reporting of periodic measures of progress toward enterprise goals. Thus, measures useful for assessing earning power are also useful for accountability. Accordingly,

An objective of financial statements is to supply information useful in judging management's ability to utilize enterprise resources effectively in achieving the primary enterprise goal.

The earning process consists of effort and performance directed at reaching the primary enterprise goal of returning over time the maximum amount of cash to its owners. The activities that are part of the earning process of the enterprise can be related to earnings cycles. An earnings cycle can be classified as completed, incomplete, or prospective. A completed earnings cycle involves a series of events whose entire impact on enterprise earnings and earning power is considered to have occurred. An incomplete earnings cycle involves a series of events underway whose full impact on enterprise earnings and earning power has not yet occurred. A prospective earnings cycle involves a series of planned events or unilateral actions. The earnings cycle concept is believed to be useful because the classifications assist users in evaluating uncertainties and the earning power of the enterprise.

Earnings as reported in financial statements have come to be, and in all probability will continue to be, the single most important criterion for assessing the enterprise's accomplishments and earning power. In the final analysis, ideal determination of earnings—the change during a period in the present values of future cash flows—can be approached no faster than the increase in user confidence in accounting measures permits. However, it seems reasonable to assume that, even in the long run, a distinction will have to be made between that portion of earnings resulting from completed cycles and estimates of recognizable progress toward the completion of incomplete cycles, and that portion of earnings arising from changes in value.

Economic decision-makers need both factual and interpretive information—identified separately to the extent possible—about transactions and other events in order to assess uncertainty. In all reporting, the assumptions, interpretations, predictions, and estimations that underlie the preparer's conclusions should be set forth. Thus,

An objective of financial statements is to provide factual and interpretive information about transactions and other events which is useful for predicting, comparing, and evaluating enterprise earning power. Basic underlying assumptions with respect to matters subject to interpretation, evaluation, prediction, or estimation should be disclosed.

Based on an analysis of users' needs, it can be concluded that

- Financial statements should emphasize information about transactions and other events that significantly affect enterprise earning power or changes in it. Such information should be stated in terms of actual or prospective cash impact and should facilitate comparisons.
- Financial statements should report both facts and interpretations about transactions and other events.

- Financial statements should assist in the assessment of the uncertainties with respect to the amount and timing of prospective cash receipts and disbursements.

- Financial statements should report on series of transactions and other events, including value changes, in terms of earnings cycles.

The Group concludes that these goals can be attained through financial statements consisting of a statement of financial position, a statement of earnings, and a statement of financial activities. Thus,

An objective is to provide a statement of financial position useful for predicting, comparing, and evaluating enterprise earning power. This statement should provide information concerning enterprise transactions and other events that are part of incomplete earnings cycles. Current values should also be reported when they differ significantly from historical cost. Assets and liabilities should be grouped or segregated by the relative uncertainty of the amount and timing of prospective realization or liquidation.

An objective is to provide a statement of periodic earnings useful for predicting, comparing, and evaluating enterprise earning power. The net result of completed earnings cycles and enterprise activities resulting in recognizable progress toward completion of incomplete cycles should be reported. Changes in the values reflected in successive statements of financial position should also be reported, but separately, since they differ in terms of their certainty of realization.

(For some time there has been consistent demand for a single earnings figure. Members of the Study Group disagree on whether value changes that meet the qualitative criteria discussed in this report should be included in earnings. Some believe the objective should be to reflect current value changes in earnings. Others believe that inclusion of unrealized value changes in earnings may be desirable but is not now practicable. Still others believe that their inclusion is neither desirable nor practicable.)

An objective is to provide a statement of financial activities useful for predicting, comparing, and evaluating enterprise earning power. This statement should report mainly on factual aspects of enterprise transactions having or expected to have significant cash consequences. This statement should report data that require minimal judgment and interpretation by the preparer.

Each of the financial statements should be structured to enhance the user's ability to assess the following.

- The extent to which sacrifices and benefits vary over time and among themselves, such as differentiation between fixed and variable expenses.
- The extent to which sacrifices and benefits vary in relation to changes in the industry and the economy.
- The extent to which the occurrence of sacrifices and benefits, or their allocation to time periods, is discretionary or arbitrary. Examples are contributions, unusual research expenditures, or the recognition of gains or losses whose timing can be controlled.
- The extent to which sacrifices and benefits are unusual or infrequent and, therefore, require special consideration for predicting, comparing, and evaluating.
- The extent to which sacrifices and benefits pertain to various lines of activity of the enterprise.

Financial statement objectives are based on the user's need for information useful for predicting, comparing, and evaluating earning power. The Study Group concludes that, to satisfy these information requirements, different valuation bases are preferable for different assets and liabilities. The objectives of financial statements cannot be best served by the exclusive use of a single valuation basis. Each of the valuation bases should be analyzed in terms of the stated objectives. Selection of the specific basis or combination of bases to be used is an implementation issue.

All economic decisions look to the future. Since economic decision-makers cannot know the future, they look to the past and the present. Financial statements that provide information about the past and the present are useful for making predictions on which to base economic decisions. In many instances, however, the past may not be a good indicator of the future. Publication of explicit forecasts of enterprise activities may well fit the objectives of financial statements. The important consideration is not the accuracy of management forecasts themselves, but rather the relative accuracy of users' predictions with and without forecasts in financial statements. Thus,

> **An objective of financial statements is to provide information useful for the predictive process. Financial forecasts should be provided when they will enhance the reliability of users' predictions.**

Many of the aspects of economic decisions concerned with governmental and not-for-profit organizations are similar to those of decisions concerning commercial enterprises. As with commercial enterprises, decision-makers are interested in predicting, comparing, and evaluating benefits and sacrifices in terms of amount, timing, and related uncertainty, even though they seek nonmonetary benefits. For governmental and not-for-profit organizations, assessments of performance should relate to the goals of the enterprise, even though these goals are essentially nonmonetary.

Managers of governmental and not-for-profit organizations are also accountable for their performance and goal attainment. Thus, reporting on such accountability is as important for not-for-profit organizations as it is for commercial enterprises. Consequently,

> **An objective of financial statements for governmental and not-for-profit organizations is to provide information useful for evaluating the effectiveness of the management of resources in achieving the organization's goals. Performance measures should be quantified in terms of identified goals.**

The objectives structure of this report, while primarily directed toward private goals, applies at least indirectly to social goals as well. The accounting objectives in this report are intended to produce financial information that will facilitate decisions that advance the common good. Thus,

> **An objective of financial statements is to report on those activities of the enterprise affecting society which can be determined and described or measured and which are important to the role of the enterprise in its social environment.**

Information contained in financial statements to satisfy users' needs should possess the qualitative characteristics of relevance and materiality, reliability, freedom from bias, comparability, consistency, understandability, and the recognition of substance over form. Information is not useful unless it is relevant and material to the user's decision. In making decisions, users should be able not only to understand the information presented, but to assess differences in its reliability, to rely on its fairness, to compare it with information about alternative opportunities, and to assess its consistency with previous presentations.

The Study Group concludes that the objectives developed in this report can be looked upon as attainable in stages within a reasonable time. Selecting the appropriate course of action for gaining acceptance of these objectives is not within the purview of the Study Group. However, the Study Group urges that its conclusions be considered as an initial step in developing objectives important for the ongoing refinement and improvement of accounting standards and practices.

Charter of the Accounting Objectives Study Group

Issued by the Board of Directors of the
American Institute of Certified Public Accountants

A Study of the Objectives of Financial Statements

The main purpose of the study is to refine the objectives of financial statements. Refined objectives should facilitate establishment of guidelines and criteria for improving accounting and financial reporting.

The study is timely because of the recent issuance of Accounting Principles Board Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises.* Chapter 4 of Statement 4 is entitled "Objectives of Financial Accounting and Financial Statements." That is, for a number of reasons, a logical starting point for a study to refine objectives, but the study should not be limited to a refinement of Statement 4.

There seems to be a consensus that the objectives set forth in Statement 4 are appropriate objectives of financial accounting and financial statements. Seven qualitative objectives are relevance, understandability, verifiability, neutrality, timeliness, comparability and completeness. They are stated in relatively abstract terms and therefore provide little guidance for preparing financial statements in accordance with them.

Statement 4 contains objectives in terms of what is considered acceptable today rather than in terms of what is needed and what is attainable to meet these needs.

In seeking to refine the objectives of financial statements, the study should consider at least the following questions:

Who needs financial statements?

What information do they need?

How much of the needed information can be provided by accounting?

What framework is required to provide the needed information?

The study will require consideration of the needs of diverse classes of users of financial statements. This suggests an inquiry into uses of that financial information which is now received and of that which is desired. It also raises the question of whether a single set of statements and a single set of standards can provide the diverse information.

The study will require consideration of criteria for determining what resources and obligations should be recorded, when they should be recorded, how they should be measured and how the changes in recorded amounts

should be reported. The study should distinguish between objectives and mechanisms for achieving objectives.

The study should obtain the views of as many interested parties as possible and should make sure that views are obtained which are representative of all segments of our society. One or more public hearings should be held. A public record should be maintained of significant proceedings of the study and of comments received from interested parties in order that background information will be available to everyone. The conclusions of the study should be explained in the light of the entire public record.

The study should report its conclusions to the Board of Directors by August 31, 1972, and should make progress reports on August 31, 1971 and March 31, 1972.

April 1971

Terminology Index

Several specialized terms are used in this report. The meaning of these terms is best understood in the context of the discussions in which they appear. The terms and pages in which they are defined or discussed are:

Accountability 25
Assets 35
Benefits 18
Comparability 59
Completed Cycles 28
Consistency 60
Cycles 27
Earnings Cycle 27
Earning Power 23
Earning Process 27
Earnings 22
Economic Income 22
Events 27
Factual Information 33
Form and Substance 57
Freedom From Bias 58
Incomplete Cycles 29
Interpretive Information 33
Liabilities 35
Primary Goal of Enterprises 21
Prospective Cycles 29
Realized Benefit 28
Realized Sacrifice 28
Recognizable Progress Toward Cycle Completion ... 31
Relevance and Materiality 57
Reliability 58
Sacrifices 18
Statement of Earnings 36
Statement of Financial Activities 37
Statement of Financial Position 35
Stewardship 25
Transactions 27
Understandability 60

Index of Selected Papers—Volume II

Preface

1. Background and Organization of the Study

Purpose and Need for Objectives
George H. Sorter, *Research Director,* in collaboration with
Martin S. Gans, Paul Rosenfield, R. M. Shannon and Robert G. Streit

Range of Potential Parameters
George H. Sorter, *Research Director,* in collaboration with
Martin S. Gans, Joshua Ronen, R. M. Shannon and Robert G. Streit

The Descriptive and the Normative
Joshua Ronen and George H. Sorter

A Framework for Developing the Objectives of Financial Statements
Richard M. Cyert and Yuji Ijiri

The Need for Accounting Objectives in an Efficient Market
Joshua Ronen

2. The Conceptual Inquiry

The Right to Know
David Herwitz

Economic Decision-Making and the Role of Accounting Information
George H. Sorter, *Research Director,* in collaboration with
Martin S. Gans, Paul Rosenfield, R. M. Shannon and Robert G. Streit

A User Oriented Development of Accounting Information Requirements
Joshua Ronen

Accounting Income and Economic Income
George H. Sorter

Earning Power and Cash Generating Ability
George H. Sorter, *Research Director,* in collaboration with
Martin S. Gans, Paul Rosenfield, R. M. Shannon and Robert G. Streit

The Partitioning Dilemma
George H. Sorter

Stewardship
Paul Rosenfield

3. **Valuation Methods**

CONCEPTUAL PAPERS—

Discounted Cash Flow Accounting
Joshua Ronen

Usefulness of Exit Value Accounting Statements in Satisfying Accounting Objectives
James C. McKeown

Replacement Cost Accounting: A Theoretical Foundation
Lawrence Revsine

EMPIRICAL PAPERS—

Company Procedures
James C. McKeown, Lawrence Revsine, Joshua Ronen and Robert G. Streit

A Test of the Feasibility of Preparing Discounted Cash Flow Accounting Statements
Joshua Ronen

A Test of the Feasibility of Preparing Exit Value Accounting Statements
James C. McKeown

A Test of the Feasibility of Preparing Replacement Cost Accounting Statements
Lawrence Revsine

4. **The Risk of Liability for Forecasting**

David Herwitz

5. **Accounting for Social Factors**

Accounting and Social Reporting
Claude S. Colantoni, W. W. Cooper and H. J. Dietzer

Accounting for Social Costs and Benefits
Joshua Ronen

6. **Illustrative Financial Statements**

7. **Bibliography**